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By

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CONTENTS

Dear Readers,

Greetings for the season!

In this edition, we bring to you certain important articles on various aspects.

We have summarised the proposals of paper released by CBDT on Rule 10 of Income Tax Rules which deals with attribution of profit to PE. This is a welcome paper by CBDT which would lead to tax certainty. We request all of you to kindly read the summary and share your comments to CBDT at the earliest.

The next article is on 'Derivates under FEMA'. In this article, we bring to you the basic concepts of derivates and the FEMA regulations applicable to such derivatives. My team also wrote a piece on the global data protection regulations.

The last article is on the recent judgment in the matter of interest payable under GST laws on the total tax liability instead of net tax liability. We have analysed certain aspects and this piece is in continuation to our earlier article, where we have argued that interest should be only on the net tax lability.

I hope that you will have good time reading this edition and please do share your feedback. I will also urge clients to mail us topics or issues on which you want us to deliberate in our future editions, so that we can contribute to the same.

Thanking You,

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INTERNATIONAL TAXATION

SUMMARY OF PROPOSALS FOR PROFIT ATTRIBUTION TO PE

Contributed by CA Suresh Babu S & CA Sri Harsha & CA Ramaprasad T

The Central Board of Direct Taxes (for brevity 'CBDT') has released a paper for public consultation on the proposals pertaining to the amendment of rules which deal with profit attribution to Permeant Establishment (for brevity 'PE'). The current rule does not lay down a universal approach for determination of profits attributable to PE, leaving to the discretion of Assessing Officer a wide power for such attribution. This has led to multiple rounds of litigations both by tax payer and revenue. The Courts also held in different matters, different profit attributions making this more complicated. Further, the tax payer is also burdened in absence of a concrete mechanism, which leads to tax uncertainty. Hence, the CBDT thought in the best interests of tax payers and to achieve a universality in attributions of profits to PE, brought out a paper for public consultation dealing with the amendments to such rules. The paper was published on 18th April 2019 and CBDT has provided a window of 30 days for providing the comments on the proposed amendments. Such comments can be mailed to usfttr-1@gov.in. In this write up, we have tried to concisely capture the key contents in the paper, so that reader can go through this write up and make his suggestions to the proposed amendments.

Background:

Before going to the proposed amendments, let us capture the context in which the amendments are being tried to brought in. Section 4 of Income Tax Act, 1961 (for brevity 'Act') is the charging section which provides income tax on the total income. Section 5 of Act deals with the scope of total income. Vide sub-section (2), the total income of a non-resident includes all income from whatever source derived which is received or is deemed to be received in India by or on behalf of such person or accrues or arises or is deemed to accrue or arise to non-resident in India. Section 9 of the Act deals with instances where income deemed to accrue or arise in India to any person. Vide Section 9(1), income accruing or arising, whether directly or indirectly, through or from any business connection in India is deemed to accrue or arise in India. Vide Explanations to such sub-section, the scope of expression 'business connection' is laid down.

Position under Domestic Act:

Hence, if a non-resident has a business connection as explained in Section 9(1), the income of such non-resident is deemed to accrue or arise in India. However, Explanation 1 to Section 9(1) states that in case of business of which all the operations are not carried out in India, the income of business deemed to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India.

Attribution under Domestic Act:

It appears to be simple to arrive at income as is reasonably attributable to the operations in India, but there are number of practical challenges to such determination. One being, the exercise as to whether a non-resident has a business connection in India or not, is completely a factual exercise and a highly subjective matter. Hence, this happens in majority of the instances at a period of time substantially different from the time of happening of the transactions. Two, it is rare that a non-resident maintains a separate set of books of accounts pertaining to Indian operations to facilitate the determination of such income which is attributable to Indian operations. Even assuming such books of accounts are maintained that determination of profits is not an easy task.

Hence, in this connection, Rule 10 of Income Tax Rules, 1962 (for brevity 'Rules') has been prescribed to determine the income of non-residents in case the income of non-resident cannot be definitely ascertained. Vide such rule, the Assessing Officer (for brevity 'AO') has been given three options to determine the income of non-resident which is subjected to tax in India to the extent of operations carried out in India. The income may be ascertained by AO – (i) at such percentage of the turnover so accruing or arising as AO may consider it reasonable (presumptive method) or (ii) on any amounts which bears the same proportion to the total profits and gains of the business (computed in accordance with the provisions of the Act) of such person as the receipts so accruing or arising bear to the total receipts of the business (proportionate method) or (iii)in such other manner as AO may deem suitable (discretionary method). Hence, it is evident that AO has given wide discretion for attribution of profits pertaining to the non-resident.

Apart from the above, the story gets more complicated in light of the Double Taxation Avoidance Agreements (for brevity 'DTAA'). Section 90 of the Act empowers the Central Government to enter arrangements with other countries to avoid double taxation of the income. Vide such section, India has entered multiple DTAA with multiple countries. Section 90(2) of Act states that the provisions of the Act will apply to the extent they are more beneficial to him. In other words, if the position as per DTAA is more beneficial than the position under the Act, the non-resident can choose the position under DTAA since the same is more beneficial to him. Hence, it assumes importance to understand the position under DTAA in terms of business connection to better understand the proposed amendments.

Position under DTAA:

There are two widely used model conventions namely OECD and UN Model Conventions. Both of them differ in various aspects, but these two are widely used model convention which all the countries use to enter respective DTAA. India has tax treaties based on UN model conventions with certain changes. OECD model conventions generally provides greater taxing rights to the residence country rather than source country. However, UN model conventions provide greater taxing rights to the source country rather than residence country.

Article 7 of such model conventions deals with 'business profits'. Vide such Article, any person carrying business in other contracting state may be taxed in such other contracting state only if there exists a permanent establishment in such other contracting state. Article 5 of model conventions deal with 'Permanent Establishment'. The concept of 'business connection' under the Act is akin to the concept of 'Permanent Establishment' under the DTAA.

Once there exists a PE in the other contracting state as per Article 5, then the profits of business will be subjected to tax in the other contracting state. In other words, the business profits cannot be brought into tax in other contracting state in absence of PE despite of the fact that there exists a business connection in terms of Section 9 by virtue of Section 90(2). The scope of PE as per the UN model convention is wider than the scope of PE in OECD model convention. Further, Article 7 states that once a PE is in existence in other contracting state, the profits of such PE shall be subjected to tax only to the extent of profits that are attributable to PE.

Attribution under DTAA:

As per Article 7(2) of UN model conventions, wherever separate accounts of PE are available and can be relied upon, such PE shall be treated as distinct and separate entity and income shall be computed under the head 'profits and gains of business or profession'. Certain payments or notional payments made by PE to the head office that may not be deductible under the provisions of Article 7(3) of model conventions as well as Section 44C of the Act will not be allowed as deductions. Once the profits can be calculated in the above manner, then invoking provisions of Article 7(4) is unwarranted. In other words, the provisions of Article 7(4) will apply only in a situation where separate accounts are not maintained or cannot be relied upon to apply provisions of Article 7(2).

Article 7(4) states that where it is customary that the contracting state attributes profits to PE by way of an apportionment, then it is permissible to apportion profits to such PE as per the customary method of contracting state, which refers back to Rule 10 of Rules as discussed above.

The Problem:

As stated earlier and as evident from the above, the problem is that the separate accounts of PE will not be generally available and even if available, the AO states the same cannot be relied. Taking this position AO, by resorting to provisions of Article 7(4) uses the Rule 10 mechanism to arrive at such profits which are attributable to the PE to the extent of Indian operations. AO uses the discretionary method which will result in huge attributions, where the tax payer have to undergo multiple rounds of litigations to get to a lower attribution. Further, the discretionary method of AO also leads to tax uncertainty.

Based on the above, the Committee has called for information from major centres, including Mumbai, Chennai, Hyderabad, Bangalore, Kolkata, Ahmadabad and Delhito understand the current methodology adopted by AOs. After a review of such information, the Committee has understood that there is little uniformity among the AOs in the manner of attribution to PE and application of Rule 10. Hence, the Committee has decided to arrive a simple, uniform and consistent method of profit attribution under Rule 10 bringing in great clarity, predictability and objectivity in the process of attribution of profits and reducing tax disputes and litigation.

The Search:

The Committee has begun the search for identification of a simple, uniform and consistent method of profit attribution. The challenge that exists to come up with a simple, uniform and consistent method are many. The main is zeroing on the method in which profits to be apportioned. Whether the profits belong to the place where the factors of production reside or where the consumers reside? This is important because, if it is said that profits arise only because of factors of production (supply side factors), then the country in which manufacturing is taken place should be entitled for the entire profits. Alternatively, if it is said, the profits arise only because of market/consumers (market side factors), then the profits belong to the such country where markets/consumers reside, leaving the state in which the factors of production reside.

Any of the above method would lead to other country losing revenue and also does not reflect the economic position of the transaction. It is beyond any doubt that profits will not exist just because of availability of factors of production or markets. Profits will be available only if both factors of production and markets are in existence. The fight is what is the weightage that should be allotted to factors of production and markets, so that each country would be eligible to tax such proportions.

In this connection, the Committee has examined the revised position under Article 7 of OECD model convention, international practices, the views of leading academicians on the current subject and also the economic basis of attributions of profits. We shall discuss them hereunder.

Revised Article 7 of OECD model convention:

Pre-2010 position:

Article 7 of OECD model convention, prior to 2010, has always suggested that profits to be attributed based on supply side factors and market side factors in absence of separate accounts of PE. The OECD Commentary on Article 7 (updated in 1977), where in it was stated that apportionment of profits should be based on one of the criteria i.e., receipts (or sales revenue), expenses and working capital, was a reasonable way of apportioning profits to PE. Thus, the position of OECD is clear till 2010 that profits has to be apportioned based on supply side factors and market side factors, further also provided guidance on when one of them as the basis for apportionment could be considered preferable to another depending upon the nature of tax payer.

Post-2010 position:

Post 2010, the OECD has introduced a concept for attribution of profits to PE namely 'Authorised OECD Approach' (for brevity 'AOA'). This concept is completely based on the 'separate entity approach', under which a PE is considered hypothetically as being a separate and independent entity from its Head Office, which performs the same or similar functions as that of an independent enterprise under same or similar conditions. The AOA uses the OECD Transfer Pricing guidelines and suggests that the profits to be attributed to the PE based on functions performed, assets employed, risks assumed. The AOA recommends two step approach to determine the profits attributable to PE, namely Step- 1: A functional and factual analysis of PE, aligned with FAR analysis and Step- 2: A comparability analysis to determine arm's length return (price) for PE's transactions.

Pre-2010 vs Post-2010:

The Committee observed that the changes are significant from two different perspectives. First, the post-2010, vide AOA, it approximated the process of profit attribution with that of transfer pricing, thereby leading to illusion that both of them are one and the same, and can be undertaken in an integrated manner by a common FAR analysis. Second, the AOA method has failed to consider the role of market side factors in contribution to the profits. The AOA has proceeded mainly attributing profits only on basis of FAR, represent market side factors and excluding sales from the equation, the contribution of market jurisdictions stands completely ignored.

The other significant change is that post-2010, OECD completely ignores the provisions of Article 7(4) by omitting it from 2010 model conventions. The impact of such an omission leads to a situation to adopt AOA, even in the situation where the separate accounts were not readily available or where they were not accurate, without taking sales into account.

The most important effect of these changes, with immense consequences for all market-based jurisdictions will stand to lose revenue, since sales is excluded from the equation in arriving at the profit attributions. The Committee also argues the attribution of profits on the basis of AOA will also effect the supply side jurisdictions in the longer run. If AOA is adopted, the market side jurisdictions will not yield any tax revenues, thereby the governments spend would take a dip, which leads to downfall of purchasing capacity, leading to lower consumption levels and thereby effecting the supply side jurisdictions to reduce the supply, which leads to reduction in profits. Hence, the Committee is of the view that AOA is not a right solution since it does not take the market side factors at all in the profit attribution exercise.

The above is the reason as to why Indian tax treaties do not contain the revised version of Article 7 which prescribes profit attribution based on FAR analysis. The Committee has observed that AOA approach restricts the taxing rights of the jurisdiction that contributes to business profits by facilitating demand, and thereby has the potential to break the virtuous cycle of taxation that benefits all the stakeholders in global economy.

Economic Basis for Allocation of Taxing Rights in respect of Income from Business:

The Committee states that the business profits of an enterprise can be generally be understood as the surplus of its business receipts over its business expenses. The average profit, which actually forms the tax base in income tax and corporate tax regimes, is constituted by surplus of total revenues over the sum of all costs. Hence, Profits = (Price per unit * Quantity of Units sold) – (Sum of marginal costs for all units + assigned sunk cost).

Thus, business profits which constitute tax base is income tax and corporate tax depend largely on two variables, sales revenue and costs. Sales revenue in turn, depends upon two variables, price per unit and quantum of units sold.

The price of goods as well as the quantum of the units sold depends upon both demand and supply, all factors influencing them. Thus, for determination of profits of an enterprise, both demand and supply are essential, and absence or inadequacy of either of them can make the enterprise unprofitable. Hence, a jurisdiction which contributes towards demand by facilitating the economy and the ability of their resident to pay or by maintenance of markets that enables sales as well as jurisdiction that contributes to the production or supply of goods, contribute towards the business profits of an enterprise. The Committee has observed that, where the economies of both contracting states in a tax treaty contribute to the business profits, there exists sufficient economic justification for profits to be allocated among them in a manner that avoids double taxation.

Options suggested by Committee:

Based on the above studies from various perspectives, the Committee has stated that India has clearly communicated the non-adoption of revised Article 7 of OECD, wherein AOA methodology is used for attribution of profits. Further, the non-adoption of revised Article 7 in India's treaties also communicates and signifies the same stand.

However, as stated earlier, a universal approach of attribution of profits is need of the hour to bring certain tax certainty and to address other connected issues. Hence, it is important to come up with a simple, uniform and consistent method of profit attribution under Rule 10, which should be in line with India's position on attribution of profits.

The Option of Formulary Apportionment:

The Committee states that this is one of the most talked about option. Vide this option, the profits are attributed basis an apportionment which consists of three factor formula. The first factor is sales, the second factor being manpower or wages, or payroll and third factor takes into account the assets or property. This approach is largely the same one which is adopted by US and is also proposed to be adopted by EU.

However, this option is not free from any challenges especially in absence of complete information. To make this option viable, the tax authorities should have jurisdiction wise sales revenue, pay roll information and assets or properties deployed. The said information is not easily available even after the roll out of CbCr (Country by Country Reporting), for the reasons that CbCr reporting requirement is applicable only to certain companies which meet the threshold and the data or information available through CbCr can be used for attribution of profits is not clear as of now. Hence, the Committee has ruled out this option even this appears to be more scientific.

The Option of Fractional Apportionment by a Uniform Method:

The profits of various jurisdictions as needed in formulary apportionment are not required to arrive at profits attributable to PE in this method. The profits are determined only by taking those profits that have been derived by the PE and thereafter apportioning them on basis of certain factors. This approach garners support from Article 7(4) and existing Rule 10 and also blessed by Indian judiciary.

The Committee states that it is India's consistent position that profits are contributed independently by demand and supply, the apportionment would need to be based on factors representing demand as well as supply. The three-factor approach of sales, manpower and assets with equal weights assigned to each of them is proposed under this model.

The Committee argues that such model takes into account the contribution of demand and as well as supply to the profit of PE, and thereby reasonable allocates profits to the jurisdiction where the consumers and markets are located as well as where the factors of production and where activities on supply side are conducted. Further, by allocating 1/3rd to sales and 2/3rd supply side, it accommodates the role of marketing activities, which would be represented by manpower and assets, leading to equitable distribution of taxing rights among the supply and demand jurisdictions. Since it is based on the information available with PE, this method solves the challenge confronted by the earlier method.

An Option for Attribution on the basis of Demand & Supply:

The Committee also explored the option for attribution of profits on basis of supply side factors by resorting to FAR as advocated by OECD in AOA along with demand side factors represented by sales. This is nothing but a fusion of revised Article 7 for supply side factors and fractional apportionment which uses sales criterion for the demand side.

The Committee states that when an Indian subsidiary contributing to the business of foreign enterprise lead to creation of PE in India, the profits need to be attributed based only the demand side factors as the supply side factors have already been taken into account in the taxable income of the Indian Entity by virtue of transfer pricing regulations. Accordingly, where profits of Indian subsidiary are arrived at after the FAR and subjected to tax in India, they can be taken as the Indian profits contributed by the supply side factors. Following the consistent approach of allocating 1/3rd profits on the basis of sales, the Committee states that weightage of attribution based on the sales can be kept @ 33%.

However, the above works out only when there is a subsidiary in India. In cases where there is no subsidiary in India and not part of profits derived from India are being subjected to tax in hands of any entity other than PE, the profits will then need to be attributed taking into account both the demand as well as supply side factors in ratio of 33:67. Since a significant portion of supply side factors reside outside India, the Committee observed that it is important to lay down a methodology for determination of supply side factors to avoid any ambiguity. For this Committee has proposed to adopt the methodology by taking a combination of 1/3rd assets, 1/6th wages and 1/6thmanpower. In absence of the above information, the AO should determine the supply side on pro-rata basis taking into account the factual matrix of case within the overall cap.

Hence, following this option, a minimum of 33% of profits derived from sales in India will invariably be attributable to the PE on basis of sales. In other words, in case of PE deriving profits from sales in India, where no part of these profits have been taxed in India in hands of any Indian Entity, the profits attributable to such PE by AO should not be less than 33% of Indian profits, if no profit is to be attributed to India on account of factors other than sales.

Profits derived from India = Revenue derived from India * Global operational profit margin

However, if the global operations are leading to loss despite of the fact that Indian operations have profits, the Committee has decided that it would be better if a floor rate is available to tackle instances of loss and accordingly arrived that a minimum of 2% of gross revenue or turnover derived from Indian operations would be justified protecting revenue interest of India. In practice, this method can be applied in following steps:

i. Determine the profits derived from Indian operations of the enterprise. In case of global losses, or its global operational profit margin is less than 2%, the profits derived from India will be taken @ 2% of the revenue from India

ii. Apportion the profits from Indian operations of PE on basis of 3 factors of sales (33% weight) and manpower and assets (67% weight).

iii. Deduction of any profits from Indian operations of the enterprise, any profits that may have already been taxed in India (for instance, in hands of Indian subsidiary which gives rise to PE of enterprise in India).

Recommendations of the Committee:

The Committee has recommended amendments to Rule 10 by taking into consideration the three factors namely, sales, employees and assets. The formula under Rule 10 shall be as under:

$$\text{Profits derived from India} * [S1/3 * ST + (N1/6 * NT) + (W1/6 * WT) + A1/3 * AT)]$$

Where,

Profits derived from India shall be higher of amount arrived by multiplying revenue derived from India and global operational profit margin or 2% of revenue derived from India

S_1 = Sales Revenue derived by Indian Operations from sales in India
S_T = Total Sales Revenue derived by Indian Operations from sales in India and outside India
N_1= Num of Employees employed with respect to Indian Operations and located in India
N_T= Num of Employees employed with respect to Indian Operations &located in & outside India
W_1= Wages paid to employees employed with respect to Indian Operations and located in India
W_T= Wages paid to employees employed with respect to Indian Operations and located in & out India
A_1= Assets deployed for Indian Operations and located in India
A_T= Assets deployed for Indian Operations and located in & out of India

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AUDIT

GENERAL DATA PROTECTION REGULATIONS

Contributed by CA Sandeep Das

General Data Protection Regulations or GDPR is the new Privacy Protection Regulation adopted on 27th April 2016 by the European Union in replacement of the earlier Data Protection Regime. The General Data Protection Regulation (GDPR) is a legal framework that sets guidelines for the collection and processing of personal information of individuals within the European Union (EU).The GDPR sets out the principles for data management and the rights of the individual, while also imposing fines that can be revenue-based. The new Data Protection Act 2018 replaces the1998 Data Protection Act.

The nucleus of the GDPR is to protect the personal data and privacy of all citizens in the EU. It makes companies accountable for the data it collect, store, analyse and use. The development will not only change the business landscape in the EU but also influence global markets and multinationals.

These privacy regulations which come with restrictions on non-transferability of EU data to non-compliant countries make it highly relevant for countries outside EU also as it could make or mar the data processing industry.

What distinguishes GDPR from the earlier regulations is the high level of penalties envisaged under the regulation which may go upto Euro 20 million (approximately Rs 140 crores) or 4% of global turnover of a company and will be applicable even for Non EU based companies.

7 Key principles for GDPR

- Lawfulness, fairness and Transparency
- Purpose Limitation
- Data minimization
- Accuracy
- Storage limitation
- Integrity & Confidentiality
- Accountability

Advantage of GDPR

Improved Cybersecurity: Organisations have been in a continuous battle for almost as long as the internet has existed. Security upgrades in networks, servers and infrastructures have been a primary source of cyber protection along with other policy and security changes until recently. Cyber security is not something a business can ignore any longer, and it is not something that they can put on the back burner and “get to later”. The GDPR makes sure that increased cyber security is made very important for companies to get right, and that is why they have large fines for those who do not get on board.

Business opportunity rather than compliance burden: Indian IT companies serving the EU market, their second largest after the US, would be required to comply with the GDPR. However, rather than seeing this as an additional burden in terms of compliance, Indian companies should see it as a massive business opportunity knocking at their doors.

Provide customer and clients more control over their data : The regulations provide the customers with some measure of peace of mind that they did not have before. It might not be a perfect system, but it is going to be better than what it was. Additionally, companies need to think about the GDPR benefits for businesses. Having leaks and data breaches at a company is going to be bad for business. Not having any breaches will be a sign of trust.

Opportunity to stand out: Over the years, India has become a technology hub equipped with deep expertise and a talented resource pool. The GDPR could be an opportunity for Indian companies to stand out as leaders in providing privacy compliant services and solutions.

Developments in India's privacy landscape: The 'adequacy requirements' under the GDPR allow the European Commission to consider whether the legal framework prevalent in the country to which the personal data is sought to be transferred affords adequate protection to data subjects in respect of privacy and protection of their data. In the wake of recent developments and the Supreme Court verdict, a data protection framework has been proposed by the Srikrishna Committee. It will be interesting to see how the forthcoming legislation shapes up and whether it will satisfy the criteria laid down under the GDPR.

Impact of GDPR on Indian Entities

Europe is a substantial marketplace for the ITeS, BPO and pharmaceutical industry in India. Thus, for the Indian IT industry to keep continuing to do business in Europe, it needs to comply with the GDPR. The GDPR imposes a substantial penalty structure in cases of non-compliances.Clearly, the GDPR would impact the service sector, especially sectors like data entry, customer care, advertising, banking and IT among others. These services cannot be provided to a European client unless the Indian data protection laws are considered adequately rigorous by EU standards or on par with GDPR.

The regulation requires a programmatic approach to data protection and a defensible programmed for compliance will be required to prove that we are acting appropriately. Due to India's relatively weak data protection laws Indian e- services industry would become less competitive and lose its European Market. Indian companies would be required to implement sufficient safeguards, as per the GDPR, to prevent transfer of personal data outside EU geographies.

Preparation for GDPR

Things which are essential for GDPR compliance:

- Review policies, procedures and existing privacy programmes;
- Conduct data discovery exercises and maintain documentation in order to demonstrate visibility of the personal data processed;
- Impart data privacy training to employees or subcontractors;
- Review / Update contracts signed with third – party vendors
- Equipping the security ecosystems with effective identity and access management
- Reviewing data retention schedules, cross-border data transfers, privacy notices, consent, etc.;
- Logging monitoring and incident management solutions;

What are the challenges Associated With the GDPR

The decision to implement the GDPR came with criticism. Those opposed to the new regulation said that the position of the DPOs could be an administrative burden for many EU countries. The guidelines were set to include social networks and cloud provider but did not consider how to deal with employee data. In addition, data cannot be transferred to another country outside the EU - unless it guarantees the same kind of protection - so companies that didn't have this kind of privacy protection would be required to change their business practices. Furthermore, the costs associated with the proposed regulation could also increase over time due to the need for more investment, and general education in data protection is also sometimes required. There was also concern that data protection agencies across the EU would need to agree to a standard level of protection, something that may not be easy as they may disagree in the interpretation of the guidelines.

Accountability & Compliance

Companies covered by the GDPR are accountable for their handling of people's personal information. This can include having data protection policies, data protection impact assessments and having relevant documents on how data is processed. The draft Protection Bill, 2018 has borrowed several provisions from GDPR to ensure that protection laws do not hamper ecommerce transaction between India and EU member countries. For companies that have more than 250 employees, there's a need to have documentation of why people's information is being collected and processed, descriptions of the information that's held, how long it's being kept for and descriptions of technical security measures in place. Organizations covered by GDPR have to hire staff, the person shall report to senior member of staff , monitor GDPR compliance and be a point of contact for the employees and customers. Even if Indian companies do not directly interact with European citizens , they would still require GDPR compliance. This is so because personal data of European citizens have the potential to be exploited for other related data processing activities. If so Indian companies would attract heavy penalty for noncompliance. Apart from convergence between the GDPR and Indian Data protection Bill 2018, the divergence relates to issues like data localization or data stored in an Indian server is mandatory.

GDPR Fines

One of the significant elements of the GDPR has been ability for regulators to fine businesses that don't comply with it. If an organisation doesn't process an individual's data in the correct way, it can be fined. If there's a security breach, it can be fined.

Conclusion :

Today, the information technology Act, 2000 (amended in 2008) provides for data protection through Sections 43A, 72 & 72A. These provisions, along with Information Technology Rules 2011, provides the legal framework to govern data privacy in India. GDPR specifically confers protection to citizens and rights to decide on how their data is processed which is not included in the IT Act. The principles under IT Act 2000 apply to collect of information and its use. Principles listed in the GDPR but not mentioned in IT Act are data integrity, protection from unlawful processing, accountability, fairness and transparency.

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GST

INTEREST - TIME TO RECONCEIVE LEGAL POSITION

Contributed by CA Sri Harsha & CA Manindar

In our last article, we have analyzed the legal provisions relating to interest payable under Goods & Services Tax (for brevity 'GST') laws towards delay in remittance of tax. Taking into consideration, the well established legal principle that interest is compensatory in nature and is required to be payable only when there is a loss to revenue for delayed remittance of tax, we have expressed our opinion that interest payable under GST law is on net liability after adjustment of input tax credit as against the view expressed by Principal Commissioner, Hyderabad vide his standing Order No. 01/2019 dated 04.02.2019. In the meantime, the Telangana and Andhra Pradesh High Court, in the case of M/s Megha Engineering and Infrastructures Limited vs CCT[1] , has expressed that interest is payable gross tax liability. In this article, we will now analyze the reasons for such conclusion by HonorableHigh Court and the probable legal proposition that can be reconceived.

While upholding the view that interest is payable on gross tax liability, the Honorable High Court has observed that a person gets credited with input tax in his electronic credit ledger only upon his filing of the return on self-assessment basis. Till a return is filed under Section 39 of CT Act[2] , no credit becomes available to his electronic credit ledger. In the absence of such credit in electronic credit ledger, no payment can be made against output tax liability in terms of section 49(2) of CT Act. The relevant extracts vide para 37is reproduced hereunder:

"37. In other words, until a return is filed as self-assessed, no entitlement to credit and no actual entry of credit in the electronic credit ledger takes place. As a consequence, no payment can be made from out of such a credit entry. ***It is true that the tax paid on the inputs charged on any supply of goods and/services, is always available. But, it is available in the air or cloud. Just as information is available in the server and it gets displayed on the screens of our computers only after connectivity is established, the tax already paid on the inputs, is available in the cloud. Such tax becomes an in-put tax credit only when a claim is made in the returns filed as self-assessed.*** *It is only after a claim is made in the return that the same gets credited in the electronic credit ledger. It is only after a credit is entered in the electronic credit ledger that payment could be made, even though the payment is only by way of paper entries"*

Further, the Honorable High Court went on to make an interesting observation vide para 40 of order with respect to availability of tax revenue at the disposal of Governments. The relevant extracts are as under:

"40. Let us look at it from another angle. Suppose a registered person under the Act purchases goods, which have suffered tax, to be used as inputs in the goods to be sold by him. Let us assume that the purchase is made in January and hence the same is reflected in the return filed by February 20. While filing the return in February, the dealer could have taken credit and it is possible that the credit is available in the electronic credit ledger for the month of February. If after some kind of processing, the goods are sold in

[1]2019(4)TMI1319-Telangana and Andhra Pradesh High Court
[2]Central Goods and Services Tax Act, 2017

March, the output tax becomes payable while filing the return by April 20. This payment can be either by way of cash or by way of adjustment against the claim for ITC. ***The payment is made by way of cheque in the case of the former and by way of a claim made in the return by way of an entry. Only when the payment is so made, the Government gets a right over the money available in the ledger. Since ownership of such money is with the dealer till the time of actual payment, the Government become entitled to interest upto the date of their entitlement to appropriate it."***

The Honorable High Court has observed that though input tax credit is claimed in electronic credit ledger, the Governments[3] get a right over the money in such ledger only when the payment is made. Till such time, the Governments are entitled to interest. In view of these observations, in the humble opinion of paper writers, it is worth to examine whether the revenue underlying the input tax credit is available for disposal of Governments or not. In this regard, it is worth to examine Goods and Services Tax Settlement of Funds Rules, 2017.

Upon perusal of overall scheme of these rules, monthly reports are prepared and shared by GSTN by consolidating the information based on GST returns filed by taxpayers pertaining to cross utilization[4] of input tax credit, settlement of integrated tax collected between Centre and respective State and other related matters. Based on such reports, the collections towards GST are apportioned between Centre and respective State Governments. Rule 4 of the said rules requires GSTN to send a monthly report of the details of cross utilization of input tax credit to the Authorities for settlement of funds between Centre and respective State. This implies that delay in availability of funds to Governments would arise on account of cross utilization of input tax credit.

As integrated tax is a pass-through tax which will be shared between Centre and States and will eventually turn out to be Central Tax and State Tax, cross utilization of input tax credit may lead to transfer of state tax component in integrated tax from one state to another state. This may lead to delay in availability of funds to Governments with respect to input tax credit available. Let us understand this with the following examples.

Scenario#1:

During January 2019, XYZ Limited of Telangana has purchased goods for Rs.10,00,000 from ABC Ltd of Karnataka. The invoice issued by ABC Ltd contains integrated tax of Rs. 1,80,000/- making the total invoice value Rs. 11,80,000/-.ABC Ltd being the vendor is required to deposit the tax amount by 20.02.2019 by filing GSTR-3B return.XYZ Limited will avail the input tax credit of Rs. 1,80,000/- in the month of January 2019 only. ABC Ltd has filed GST returns within due date and has paid the tax accordingly. This implies that the consuming state i.e. Telangana and Centre will get their share of revenue[5] within the due date.

[3]Central Government and corresponding State Government

[4]Central tax and State tax adjusted with Integrated tax or vice versa.

[5]Centre will get central tax component of integrated tax (Rs 90000) and State will get state tax component of integrated tax (Rs 9000)

Suppose XYZ Ltd has sold these goods in the month of March 2019 for Rs. 15,00,000 to a customer in Tamil Nadu by charging integrated tax of Rs. 2,70,000/-. The due date to make tax payment by filing GSTR-3B return is 20.04.2019. The return has been filed on 10.05.2019 and part of the payment was made using input tax credit of Rs. 1,80,000. In this scenario, the revenue is required to be obtained by the consuming State i.e. Tamil Nadu and Centre. As the revenue of input tax credit was with Telangana and Centre until the return has been filed by XYZ Ltd, we understand that there is a delay in receipt of revenue.

The interesting questions to be considered in this scenario is how much the real revenue short fall for the Centre and State would be. Coming to Central Tax, upon filing of return by vendor of XYZ Ltd, Centre would have received there share of underlying revenue in input tax credit i.e. Rs 90,000 (1,80,000/2) within the due date. If there is a delay in making adjustment of this tax with the output integrated tax of XYZ Ltd, there will not be any revenue loss because tax was already accrued to Centre. The revenue loss will only arise to the extent of cash payment i.e.Rs 45,000(90,000/2). Coming to state tax, upon filing of return by vendor of XYZ Ltd, the state tax portion of integrated tax paid by him would have been accrued with Telangana state. As the integrated tax payable by XYZ Ltd is accruing in the state of Tamil Nadu, any delay in payment of tax by filing return would result into revenue loss to the extent of both input tax credit and cash payment. Therefore, there would be a revenue loss with respect to state tax of Tamil Nadu.

Scenario#2:

Let us assume that in the above example, XYZ Ltd has sold the goods within the state of Telangana instead of Tamil Nadu. In such event, there won't be any loss of revenue even with respect to state tax portion of integrated input tax availed because, even after utilization of input tax credit, the tax accrued to Telangana state will remain with the same state.

Based on the above examples, the following propositions arise with respect to revenue loss on account of cross utilization of input tax credit:

a) With respect to central tax portion of integrated tax that was availed as input tax credit and used for payment of outward tax, there will not be any short fall of revenue as tax was unconditionally accrued to Centre based on compliance of the preceding taxpayer in the supply chain.
b) With respect to state tax portion of integrated tax that was availed as input tax credit and used for payment of outward tax, there will be a short fall of revenue if the subsequent supply is an inter-state supply and the input tax credit adjusted with output tax is required to be transferred to other state.

In other words, there will not be any short fall of revenue on account of delay in adjustment of input tax credit with respect to central tax is concerned. Coming to state tax, the delay would happen only when there is a cross utilization i.e. integrated tax input set-off with state tax or vice versa.

In addition to the above, the other interesting aspect that needs to be considered in the above context is that such reports of cross utilization can only be prepared by GSTN only when GSTR-1[6] return has been filed within the due date. In this context, what would be the situation where a taxpayer files his GSTR-3B return within due date by paying taxes while the corresponding GSTR-1 return has been filed after the due date.

Interestingly, the GST Council in their 31st Meeting has recommended amendment to section 49 of CT Act that interest should be charged only on the net tax liability of the taxpayer after considering the admissible input tax credit. Subsequent to the decision of High Court, representations were made to GST council to implement the said amendment with retrospective effect.

It is a settled legal principal in indirect taxes that interest is compensatory in nature and is required to be payable only when there is loss to revenue on account of delay in remittance of tax. In the erstwhile regime, with respect to input tax credit, the underlying tax component is always accrued to the revenue[7]. However, considering the architecture of GST law being dual levy and consumption based, at times due to cross utilization of input tax credit, there will be loss to revenue on account of delay in making tax adjustment of input tax credit available. In view of the changed architecture of indirect tax law and based on the observations made by High Court, it is of paramount importance to reconceive the rationale in collection of interest and accordingly, the GST council is required to make an appropriate revisit to the recommendations given earlier strike a fair balance from taxpayer and revenue point of views. Otherwise, this would lead to vexatious litigation.

[6]Place of consumption details would be available based on GSTR-1 return

[7]This proposition was explained in detail in our previous article. In this regard, kindly refer

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FEMA

DERIVATES UNDER FEMA

Contributed by CA Murali Krishna G & CA Bharani

What is a Derivative?

A Derivative is a (financial) security or instrument, the value of which depends on underlying asset or group of assets or a benchmark. It is a contract between two or more parties, and its price is determined by fluctuations in the underlying asset. Examples of underlying assets in case of derivatives are shares /stocks, bonds, indexes, currencies, interest rates and commodities.

Derivatives are most commonly used to hedge the risk of abnormal fluctuations, be it price of share or interest rate or exchange rates of currencies. At the same time, derivatives are also used as a speculation tool where the speculators engage in trading them with an objective to gain (arbitrage) from such abnormal fluctuations. Most commonly used derivative contracts as Forward Contracts, Exchange Traded Futures and Options (in stocks and currencies), Interest Rate Swaps, Currency Swaps, etc.

Regulatory environment in India

As a capital market regulator, SEBI is the primary regulator governing derivatives in India. History of derivatives in India dates to 1998, when SEBI accepted the recommendations of Dr. L C Gupta Committee and approved phased implementation of derivatives trading in India, beginning with stock index futures. Necessary infrastructure was created in the form of introducing separate segment on stock exchanges and clearing house therefor, approvals for trading members, putting in place risk containment measures, disclosure requirements, etc. Accordingly, in May 2000, SEBI gave its approval to stock exchanges (BSE and NSE only at that time) to commence derivatives trading. Over a period, multiple derivative products were introduced on stock exchanges for trading.

As a foreign exchange regulator in India, Reserve Bank ("RBI") issued Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations in May 2000 ("Derivative Regulations"). These regulations were amended time to time in line with improvements (at national and international levels) in derivatives market. These regulations provide detailed guidelines, separately for persons resident in India and non-residents, about general permission, limitations, eligible derivative products, exposures that can be covered, etc. As like any other FEMA regulation, prior approval of RBI is required to enter into any derivative contract, unless it is expressly permitted in the derivative regulations or any other FEMA regulation. In addition to Derivative Regulations, RBI's AP (DIR Series) Circulars and FMRD Master Direction No. 1/2016-17 on Risk Management and Inter-Bank Dealings also governs derivation transactions under FEMA.

Derivatives under FEMA

Under FEMA, a Foreign Exchange Derivative Contract("FEDC") means a financial transaction or an arrangement in whatever form and by whatever name called, whose value is derived from price movement in one or more underlying assets, and includes:

a. a transaction which involves at least one foreign currency other than currency of Nepal or Bhutan, or
b. a transaction which involves at least one interest rate applicable to a foreign currency not being a currency of Nepal or Bhutan, or
c. a forward contract,

but does not include foreign exchange transaction for Cash or Tom or Spot Deliveries.

In case of a Cash Delivery, delivery of foreign exchange, as part of settlement of contract, happens on the same day of transaction. In case of Tom Delivery, it happens on a working day next to the day of transaction and in Spot Delivery, it happens on second working day after the day of transaction.

Exchange Traded Currency Futures and Currency Options (including cross currency options), Interest Rate Swap, Currency Swap (including Cross Currency Swap) and Coupon Swap are the derivative products allowed under Derivative Regulations in addition to Forward Contracts. Any other type of derivative product will be requiring prior approval of RBI.

As explained earlier, derivatives are commonly used to hedge the risk of fluctuations. As such, both persons resident in India (PRI) and non-residents are exposed to risk of foreign exchange rate fluctuations. While a PRI will have exposure to transactions like foreign currency loans taken, investments made abroad, outstanding receivables or payables towards exports and imports, a non-resident will have similar exposure as a counter party to such transactions. Accordingly, Derivative Regulations provide guidelines applicable to transactions by PRIs and non-residents. It may be noted that certain FEMA regulations, like in ECBs, provide for mandatory hedging of such exposures. Any derivative contract under FEMA shall be through authorized dealers only. In case of Exchange Traded Contracts ('ETC'), delivery of underlying currency is not permitted.

Currency Futures:

As per Derivative Regulations, Currency Futures means a standardised foreign exchange derivative contract traded on a recognized stock exchange to buy or sell one currency against another on a specified future date, at a price specified on the date of contract, but does not include a forward contract.

These exchange traded currency futures were introduced by SEBI in August 2008, and correspondingly RBI issued Currency Futures (Reserve Bank) Directions, 2008 in the same month. Initially trading was allowed only for USD-INR pair futures. Subsequently in Jan 2010, SEBI allowed trading of EUR-INR, JPY-INR and GBP-INR currency futures. Accordingly, RBI vide AP (DIR Series) Circular No. 27, dated 19.01.2010, amended Currency Futures Directions allowing trading in the new currency pairs.

In addition, cross currency futures (i.e., futures not involving rupee as a currency to the contract) were allowed by RBI to be traded vide AP (DIR Series) Circular No. 35, dated 10.12.2015. Such cross-currency futures were allowed in EUR-USD, GBP-USD and JPY-USD currency pairs. Corresponding approval towards trading in such cross-currency futures was given by SEBI to stock exchanges in March 2016.

In case of currency futures contracts, the maturity of the contract shall not exceed 12 months. The membership of the currency futures market of a recognized stock exchange shall be separate from the membership of equity derivative segment and the cash segment. AD Bank can become trading members of currency futures markets subject to fulfilling prudential norms being minimum net worth of INR 5,000 Million, Capital to Risk Assets Ratio(CRAR) of 10%, net NPA not more than 3% and have net profits for last 3 years.

Derivative Contracts permissible to persons resident in India (PRI):

Regulation 4 of Derivative Regulations permits a person resident in India (PRI) to enter in to an FEDC in accordance with provisions contained in Schedule I annexed thereto, to hedge an exposure to risk or otherwise, in respect of a transaction permissible under the Act, or rules or regulations or directions or orders made or issued thereunder. And Regulation 5A of said regulations permit a PRI to enter in to exchange traded currency futures or currency options to hedge their exposures to risk. Such exposure can be either contracted (i.e., already existing) or probable exposure (i.e., futuristic), and it can be out of capital account or current account transactions. For ease of understanding the provisions, we shall discuss them derivative product wise, because the usage of derivative products is restricted to limited purposes.

1. Foreign Currency Forward Contract (FC):

It is a most common derivative product used for hedging. Under an FC, the parties agree to execute the transaction at a pre-determined rate and a pre-determined price. Both the parties must execute the contact on due date mandatorily. Unlike futures and options which are governed by stock exchanges, a forward contract is an over the counter (OTC) derivative product and has higher risk of non-execution by either party.

PRIs can use FCs to hedge exchange rate risk in relation to any transaction for which purchase / sale of foreign exchange is permitted under FEMA and its rules / regulations, which includes overseas direct investment in equity and loans, balances in foreign currency accounts, imports, including transactions denominated in foreign currency but settled in INR.

2. Cross Currency Options

PRIs can use cross currency options to hedge exchange rate risk arising out of trade transactions and to hedge contingent foreign exchange exposure arising out of submission of a tender bid in foreign currency. This is in addition to FCs.

3. Foreign Currency (FCY) – INR Option

As like forward contract, FCY-INR options can be used to hedge the exchange rate risk in relation to any transaction for which purchase / sale of foreign exchange is permitted under FEMA. In addition, it can also be used to hedge the risk arising out of submission of a tender bid in foreign currency. To issue such derivative contracts, AD Banks should meet aforesaid prudential requirements being minimum net worth of INR 5,000Million, CRAR of 10%, having net profits for past three years and having NPAs not exceeding 3%.

4. Foreign Currency (FCY) – INR Swaps

Using anFCY-INR swap, residents can move from their foreign currency liability to rupee liability. Similarly incorporated resident entities can move from their rupee liability to foreign currency liability (INR-FCY swap). This is done to hedge exchange rate and / or interest rate risk exposures on their long-term borrowings / liabilities (i.e., with period more than one year).No swap transactions involving up front payment of rupees or its equivalent in any form shall be undertaken.

5. Cost Reduction Structures

This covers cross currency option cost reduction structures and FCY–INR option cost reduction structures. These are permitted only to listed companies and their subsidiaries / joint ventures / associates having a common treasury and consolidated balance sheet or to unlisted companies with a minimum net worth of INR 2,000Million and the purpose is to hedge foreign exchange rate risk arising out of trade transactions, ECBs and foreign currency loans availed domestically against FCNR(B) deposits. In case of trade transactions being the underlying, the tenor of the structure shall not exceed two years.

General guidelines, terms and conditions in case of transactions by PRI:

a. The maturity and tenor of the hedge / swap shouldn't exceed the maturity/ tenor of the underlying transaction.
b. In case of foreign currency loans or bonds, they will be eligible for hedging only up on final approval RBI and up on allotment of Loan Registration Number (LRN).
c. GDRs and ADRs will be eligible for hedging only upon finalization of issue price.
d. In case of contracted exposures, forward contracts with residual maturity of less than one year can be easily cancelled and rebooked.
e. In case of cross currency options, only plain vanilla European options, both call and put options, can be issued by AD Bank
f. FCY-INR options can be issued by AD Bank who meet additional criteria (like adequate internal control and mark to market mechanism, net worth of INR 3,000Million etc) set by RBI and that too with its prior approval.
g. In case of all forex derivative transactions other than INR-FCY currency swaps i.e. moving from INR liability to foreign currency liability, AD Bank shall take a declaration from the constituents that the exposure is unhedged and has not been hedged with another AD Bank. However, if a part of exposure is hedged with one AD Bank, the remaining can be hedged with another AD Bank, subject to a declaration in this regard.
h. An annual certificate from the statutory auditors should be submitted in case of contractual exposure to the effect that the contracts outstanding with all AD category I banks at any time during the year did not exceed the value of the underlying exposures at that time

i. Only one hedge transaction can be booked against a particular exposure or part thereof for a given time period.
j. Residents, other than individuals, are permitted to hedge their commodity risk and freight risk using appropriate derivative products (like forwards, swaps, futures, options or a any combination of them.

Special Dispensation:

RBI allowed Small and Medium Enterprises to hedge their direct or indirect exposures to foreign exchange risk through Forward Contracts without production of underlying documents, subject to other conditions specified in this regard.

Similarly, resident individuals, firms and companies can hedge their foreign exchange exposures, arising out of both actual as well as anticipated remittances, inward and outward, without production of underlying documents, up to a limit of USD 1 Mn, based on a declaration. For this purpose, they can use forward contracts and FCY-INR options. The tenor of such instruments shall be up to one year only.

Derivative Products for Probable Exposures:

PRIs are eligible to hedge their probable exposures (i.e., exposures which are not yet contracted) in case of imports and exports of goods and services. Such probable exposure shall be calculated based on past performance. The maximum exposure for derivative product in such case shall be the higher of average turnover of actual exports / imports of past three financial years or the previous year's actual import or export turnover.

The above limits shall be calculated for imports and exports separately. Higher limits, if any, will be permitted by RBI (Chief General Manager, Financial Markets Regulation Department of RBI) based on an application made in this regard. AD Bank while issuing a derivative under this category may insist for an undertaking that supporting documentary evidence will be produced before the maturity of all the contracts booked.

Derivative Contracts permissible to non-residents:

Regulation 5 and 5B read with Schedule II of Derivative Regulations allow non-residents (i.e., person resident outside India) to enter in to a FEDC or ETC to hedge an exposure to risk in respect of a permitted current account transaction, rupee denominated asset held by such non-resident or his rupee denominated rupee liability or any other transaction permissible under the FEMA or rules or regulations or directions or orders made or issued there under, subject to such conditions as may be prescribed by RBI.

Foreign Portfolio Investors (FPIs), non-resident Indians (NRIs), investors having FDI in India, non-resident importers and exporters, non-resident lenders having ECB designated in INR are the categories of non-residents who usually have exposure and accordingly hedge them. Below are the guidelines / provisions, as applicable to each category of non-residents.

Foreign Portfolio Investors:

FPIs can use derivative products to hedge currency risk on the market value of investment in equity and / or debt in India, coupon receipts arising out of such investments in debt securities and to hedge transient capital flows in case of IPOs. Derivative products being forward contracts, currency futures and FCY-INR options can be used to hedge their investments, other than IPO related where FCY-INR swaps only can be used.

The FPI should provide a quarterly declaration to the custodian bank that the total amount of derivatives contract booked across all AD Banks is within the market value of its investments. The hedges taken by FPIs with AD banks other than designated AD banks must be settled through the Special Non-Resident Rupee Account(SNRR) maintained with the designated bank through RTGS/NEFT. The cost of hedge should be met out of repatriable funds and /or inward remittance through normal banking channel. All outward remittances incidental to the hedge should be net of applicable taxes.

In case of exchange traded currency futures and options, FPIs can take positions without having to establish underlying exposures up to such limits as may be prescribed by RBI, SEBI or stock exchanges.

Non-Resident Indians (NRIs)

NRIs can use forward contracts, FCY-INR options and exchange traded currency futures to hedge the exchange rate risks on the market value of investments made under portfolio investment scheme (PIS), on amount of dividend due on shares held in Indian companies, on the amounts held in FCNR(B) deposits and on balances held in NRE accounts. Additionally, in case of FCNR(B) accounts, cross currency forward contracts to convert the balances in one foreign currency to other foreign currency are permitted.

One should note that all foreign exchange derivative contracts permissible for a resident outside India other than a FPI, once cancelled, are not eligible to be rebooked.

Other Non-Residents:

A non-resident can enter into a forward contract with an AD Bank in India to hedge currency risk on dividends receivable from him from an Indian company or to hedge the currency risk arising out of his proposed foreign direct investment in India. Similarly, non-resident importer / exporter can enter into a forward contract or FCY-INR option contract to hedge the currency risk in respect of imports from or exports to India invoiced in INR.

A non-resident can enter into a forward contract or FCY-INR option or FCY-INR swap contract with an AD Bank in India to hedge currency risk in respect of ECB denominated in INR.

A non-resident parent company can enter into any FEDC with an AD Bank in India to hedge an exposure of exchange risk of and on behalf of its Indian subsidiary in respect of the said subsidiary's transactions. This facility shall be subject to a tri-partite agreement between the AD Bank, parent company and Indian subsidiary clearly defining the relationship, relative roles and responsibilities and the procedure of transactions including settlement. The non-resident parent should be from FATF compliant country.

Simplified Hedging Facility

RBI, vide AP (DIR Series) Circular No. 11, dated November 12, 2017, brought the scheme of Simplified Hedging Facility with a view to simplify the process for hedging exchange rate risk by reducing documentation requirements, avoiding prescriptive stipulations regarding products, purpose and hedging flexibility, and to encourage a more dynamic and efficient hedging culture. The scheme can be used by both residents and non-residents, other than individuals, to hedge the exchange rate risk on transactions, permissible under FEMA, covering both actual and anticipated exposures. Any OTC derivative or exchange traded currency derivative can be used for this purpose.

Under the said scheme, the cap on total outstanding contracts is USD 30 Mn or its equivalent, on gross basis and the transactions should be routed through an AD Bank designated by such user. If hedging requirement of the user exceeds the limit in course of time, the designated bank may re-assess and, at its discretion, extend the limit up to 150% of the stipulated cap.Users are not required to furnish any documentary evidence for establishing underlying exposure under this facility. Users may, however, provide basic details of the underlying transaction in a standardised format, only in the case of OTC hedge contract.

Facilities to Category I Authorised Dealers (ADs)

a. ADs are permitted to hedge interest rate and currency risks associated to their foreign exchange asset-liability portfolio by using interest rate swap, interest rate cap / collar, currency swap or forward rate agreement including currency options. However, they should have an internal policy approved by their top management in this regard.

b. Similarly, AD Banks authorized by RBI to operate gold deposit schemes or which are authorised to enter into forward gold contracts in India can use any exchange traded or OTC derivative product available overseas to hedge gold prices.

c. Foreign banks operating in India can hedge their capital funds by using forward contracts subject to such other conditions specified by RBI.

d. AD Banks can participate in currency futures and exchange traded currency options market in India subject to aforesaid other prudential norms being minimum net worth of INR 5,000Million, CRAR of 10%, having net profits for past three years and having NPAs not exceeding 3%.

It may be observed from the above that India has offered diversified and risk reward basis Derivative Structures and one can hedge their Foreign Exchange Risk, without much room for speculative trading. One can judiciously use the available derivative products and hedge the risk.

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